November 30, 2004

The Honorable Joseph Zarelli, Chair
Senate Ways and Means Committee
316 John A. Cherburg Building
Post Office Box 40405
Olympia, Washington 98504-0405

The Honorable Jim McIntire, Chair
House Finance Committee
314 John L. O'Brien Building
Post Office Box 40600
Olympia, Washington 98504-0600

Re: Municipal Business and Occupation Tax Studies 2004 Progress Report

Dear Chairs Zarelli and McIntire:

Enclosed is the progress report for two legislatively mandated studies on the fiscal impacts to taxpayers and cities from Engrossed House Bill 2030 (ESB 2030).

The Department of Revenue's Legislation and Policy and Research Divisions prepared this report. If you have any questions, please contact Don Gutmann at (360) 570-6073. Copies of this report are being distributed to each member of your committees as well as committee staff.

Sincerely,

Russ Brubaker, Assistant Director

Enclosure

cc: The Honorable Gary Locke, Governor
Patsy Ellis, Office Manager, Governor's Executive Policy Office
Irv Lefberg, Chief of Forecasting, Office of Financial Management
Jim Hedrick, Executive Policy Analyst, Office of Financial Management
Jim Schmidt, Executive Policy Analyst, Office of Financial Management
William N. Rice, Director
Ralph Osgood, Deputy Director
Mary Welsh, Assistant Director, Research Division
Suzanne Mager, Legislative Coordinator

Background

In 2003, the Legislature enacted Engrossed House Bill 2030 (EHB 2030), which provides for a more uniform system of municipal business and occupation (B&O) taxes. It directs the Association of Washington Cities (AWC), with input from the business community, to adopt a model ordinance to serve as a foundation for municipal ordinances that impose a gross receipts business and occupation tax. The model ordinance must contain certain mandatory provisions, such as uniform definitions and administrative provisions, a system of credits developed to address multiple taxation of gross income, and a system to allocate and apportion gross income among the cities. The legislation authorizes cities to deviate from the non-mandatory provisions of the model ordinance. Cities imposing business and occupation taxes must adopt the model ordinance by December 31, 2004. Cities that fail to adopt the model ordinance by the deadline may not continue to impose the municipal B&O tax. Cities that impose a municipal B&O tax after 2004 must adopt the model ordinance.

EHB 2030 directs the Department to conduct two studies. The first study is entitled the "Baseline Study" and is due to the Governor and the Legislature by December 31, 2004. The second study is entitled the "Allocation and Apportionment Study" and is due to the Governor and the Legislature by November 30, 2005. The legislation requires the Department to provide progress reports on the Allocation and Apportionment Study to the fiscal committees of the Legislature on November 30, 2003 and November 30, 2004.

Advisory Committee

EHB 2030 directs the Department to use and regularly consult with an advisory committee while conducting the studies. Advisory committee members include an equal number of representatives from interested businesses and from cities imposing municipal B&O taxes. Most of the advisory committee members participated in the 2001 Municipal Tax Work Group convened by Department at the Governor's request to explore alternatives to simplify municipal business and occupation taxes. The advisory committee members are noted in the Department's 2003 progress report.

Model Ordinance Finalized

In July 2004, the Association of Washington Cities and its municipal members finalized the model ordinance and the model ordinance administrative provisions. All cities currently imposing a municipal B&O tax must adopt the model ordinance by December 31, 2004.

Baseline Study

EHB 2030 directs the Department to compare the definitions used in the model ordinance noting any deviations from the definitions in Chapter 82.04 RCW, the reason for such deviation and the fiscal impact on taxpayers. For purposes of the study, the advisory committee and the Department agree that "taxpayers" mean only those taxpayers in the 39 cities currently imposing a municipal B&O tax. "Fiscal impact" is the measure of the difference between the model

ordinance and the state definitions on all taxpayers located in the cities imposing a municipal B&O tax.

Table 1 summarizes the Department's findings for the deviations in the model ordinance and the model ordinance administrative provisions.

Table 1
Summary of Model Ordinance Deviations

Definitional Area	Chapter 82.04 RCW	Model Ordinance
Manufacturer	Out-of-state persons owning materials processed in Washington **are not manufacturers**.	Out-of-city persons owning materials processed in the city **are manufacturers**. This is an optional provision of the model ordinance.
To manufacture	State law **excludes**: • Conditioning of seed • Cubing hay • Seafood processing • Agricultural activities	The model ordinance **does not exclude**: • Conditioning of seed • Cubing hay • Seafood processing • Agricultural activities
Retail sale	State law **includes** retail services.	The model ordinance **excludes** retail services.
Successor (person)	Persons **buying more than 50% of the fair market value of the tangible or intangible assets** of a person going out of business are successors.	Persons **buying any tangible personal property** from a person going out of business are defined as successors.
Successor (merged corporations)	Surviving corporations of a statutory merger **are** successors.	Surviving corporations of a statutory merger **are not** successors.

In April 2004, the Department met with the advisory committee to discuss the methodology to calculate fiscal impacts for the baseline study. The Department quantified the fiscal impacts of the deviations using available information, including employment security data, state business and occupation (B&O) tax records, input-output service data, and other Department data. Fiscal impacts were questioned by cities and business representatives. Cities are providing data on specific industries to refine the fiscal impacts at a jurisdictional level. The report will be delivered to the Governor and the Legislature by December 31, 2004.

Allocation and Apportionment Study

EHB 2030 requires the Department of Revenue to conduct a study of the net fiscal impacts of the legislation with particular emphasis on the apportionment and allocation methods contained in Section 13. As part of its report, the Department is to examine and to recommend options to address any adverse revenue impacts to the local jurisdictions.

Apportionment Formula

In August 2004, the Department wrote to the Association of Washington Business (AWB) and Association of Washington Cities (AWC). The Department specifically requested AWC's assistance with resolving interpretive issues to have a clear understanding of the apportionment formula to be studied. In order to meet our legislative obligations, the Department asked that we reach an understanding with the cities on the study's assumptions by November 15, 2004. AWC's response to this request is as follows:

> When HB 2030 was introduced we were unable to determine how to implement apportionment. We testified to that effect before the Legislature. We do not believe the issue was clarified prior to passage and the Governor signing EHB 2030. We understand you need a definition of apportionment prior to beginning the study. We believe it is appropriate for the original sponsors of the legislation to define exactly how apportionment will be implemented.

The Department met with the advisory group on November 17, 2004 to present its interpretation of the apportionment formula as written in Section 13 of EHB 2030. Attached to this report is a copy of the interpretation presented to the advisory committee. There are issues regarding the Department's interpretation of the apportionment formula.

Although advisory committee members did not disagree with the Department's interpretation, members expressed uncertainty about accepting the formula given its complexity. As a result, the advisory committee requested that the Department develop examples to further explain how taxpayers would apply the apportionment formula. The Department is preparing the examples and will discuss them with the advisory committee. However, to date, the Department's interpretation of the apportionment formula has not been fully accepted.

The advisory committee members and the Department agree that Section 13 of EHB 2030 contains an error in EHB 2030. Section 13(2) *allocates* royalty income to the commercial domicile of the taxpayer and does not *apportion* it. However, Section 13 (4) (f) includes royalty income in the definition of "service-taxable income" or "service income" which is part of the service income factor of the apportionment formula.

The Department would prefer to proceed with the study by excluding royalty income from the measure of "service income" and "service-taxable income" because the Department and the advisory committee believe this was legislative intent. However, corrective legislation or a commitment from the chairs of the Legislature's fiscal committees will be necessary before the Department feels it can deviate from the plain language of the statute.

Study Data

In the August 2004 letter to the Association of Washington Business (AWB) and Association of Washington Cities (AWC), the Department also requested assistance in the collection of data from the municipal tax returns to verify and modify key assumptions in the study, and thus, improve the accuracy and quality of the study.

At the November 17, 2004 meeting, the advisory committee and the Department agreed to work cooperatively with the cities to design an informational return to collect service income data from the firms. The cities will insert the informational return into their municipal B&O tax returns for first two quarters of 2005 and forward completed informational returns to the Department.

Although the informational return is brief, this option places an administrative burden on taxpayers to report information not necessary to determine the tax due. The Department is concerned that taxpayers will not voluntarily respond accurately to unfamiliar, and from the taxpayer's perspective, seemingly unnecessary questions on a separate form. There is no penalty for failing to complete and return the informational return. The information is not readily available or maintained by most taxpayers. In addition, the data will be collected for only a short period of time – two quarterly tax returns.

If the response rate or accuracy of the informational returns is low, the Department is limited to using Washington input/output tables to estimate the impact of the new apportionment formula on service income at the city level. Using Washington input/output tables will substantially reduce the confidence in the study's estimate.